Business Investment and a Repeal of the Corporate Alternative Minimum Tax

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Summary

With the U.S. economy either stuck in a recession or entering what some analysts anticipate will be a protracted period of sluggish recovery, Congress is considering various proposals to stimulate the economy. One such proposal – H.R. 3090, which the House narrowly passed on October 24, 2001– contains a variety of individual and business tax cuts, including a repeal of the corporate alternative minimum tax (CAMT). This report assesses the likely stimulative effect of repealing the CAMT.

A central aim of the CAMT is to prevent corporations that report substantial profits to shareholders from paying little or no federal income tax. Current tax law requires corporations to compute their tax liabilities under the regular income tax and CAMT and pay whichever is greater. Though it adheres to many of the rules of the regular tax, the CAMT applies a lower and fixed statutory rate to a broader definition of taxable income and a less generous set of deductions. Differences in the timing of certain deductions – especially for depreciation allowances – account for much of the increase in tax liability under the CAMT. Firms paying the CAMT are granted a credit for those payments, which may be used only to offset future regular taxes.

It appears that both the absolute and relative importance of the CAMT as a source of federal revenue shrank in the 1990s. In 1998, the most recent year for which data are available, CAMT payments totaled $3.3 billion, their lowest level since 1987, the first year of the tax. Similarly, the CAMT's share of total corporate income tax revenue was 1.8% in 1998, down from a peak of 8.4% in 1990. These declines are thought to stem from three significant modifications to the tax enacted in the 1990s and the pro-cyclical nature of the tax.

Income taxes affect business investment mainly through their impact on the cost of capital. Increases in taxation raise this cost, decreasing the number of investment projects that are undertaken, and vice versa. Owing to its design, the CAMT may or may not increase a firm's cost of capital relative to the regular income tax. Key determinants of its effect on this cost include a firm's initial tax status, the duration of its exposure to the CAMT, the assets being purchased, and financing method.

Because the CAMT appears to have an ambiguous effect on the cost of capital, its repeal would be likely to affect business investment primarily through increasing the cash flow of firms affected by the CAMT. Although increased cash flow often is associated with rising business investment, current economic conditions make it unlikely that an increase in the cash flow of the corporations paying the CAMT would lead to a substantial short-term increase in this investment. Many economists contend the adoption of temporary investment tax incentives (e.g., a one-year, 30% expensing allowance for purchases of equipment) would be likely to impart a bigger stimulus to short-term business investment at a lower budgetary cost. A repeal of the CAMT and immediate rebate of unused CAMT credits could improve the economy's long-term growth prospects, but it would do little to spur growth in the short run. This report provides background information and will not be updated.

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Reacting to signs that the U.S. economy has sunk into a recession that may have been exacerbated by the terrorist attacks of September 11, 2001, the 107th Congress is considering various proposals for stimulating short-term economic growth. In the aftermath of the attacks, the Federal Reserve has lowered the federal funds interest rate in stages from 3.5% to 1.75%, and Congress and the Bush Administration have agreed on measures to provide $40 billion in emergency supplemental appropriations for national security and rescue and rebuilding efforts, and $20 billion in grants and loan guarantees for U.S. air carriers. At the moment, two key issues facing lawmakers are whether additional stimulus measures should be adopted and, if so, what form they should take.

It appears that the longest peacetime expansion of the U.S. economy in history has ended. During the first three quarters of 2001, GDP grew at an anemic annual rate of 0.4%; and the latest estimate by the Commerce Department indicates that GDP contracted at an annual rate of 1.1% in the third quarter of 2001.[1] A principal factor in the sharp decline in U.S. economic growth since mid-2000 has been a contraction in business investment. From the third quarter of 2000 to the third quarter of 2001, real fixed nonresidential investment fell 6.0% while real GDP expanded 0.6%. Similarly, the unemployment rate, which reached an expansion low of 3.9% in September 2000, rose to 5.8% in December 2001. Moreover, the National Bureau of Economic Research's Business Cycle Dating Committee, the unofficial arbiter of shifts in the U.S. business cycle, recently announced that a recession began in March 2001, precisely 10 years to the month that the previous recession ended.[2]

There is, however, some evidence that the recession may prove mild and short-lived: the Commerce Department reports that GDP rose by a revised 1.4% annual rate in the fourth quarter of 2001; and the unemployment rate dipped to 5.6% in January 2002, as the number of jobs lost was much less than expected. Some analysts contend that these and other recent economic data undermine the argument that further fiscal stimulus is needed to spark an economic expansion in 2002.[3]

A central focus of the congressional debate over the need for added economic stimulus has been the desirability of a variety of proposed tax cuts on top of those already enacted through the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16). On October 24, 2001, the House narrowly passed an economic stimulus package (H.R. 3090: the Economic Security and Recovery Act of 2001).[4] The measure contained a variety of individual and business income tax cuts, including a three-year, 30% expensing allowance for business purchases of certain assets, and a repeal of the corporate alternative minimum tax (CAMT) coupled with an immediate refund of unused or accumulated CAMT credits. On the whole, it would reduce taxes by an estimated $99.5 billion in FY2002 and by an estimated $159.4 billion from FY2002 to FY2011; the estimated revenue loss from the repeal of the CAMT is $25.4 billion in FY2002 and $24.1 billion from FY2002 to 2011.[5] Following a partisan debate over the best approach to reviving the

[1] For an overview of recent trends in the U.S. economy, see CRS Report RL30329, *Current Economic Conditions and Selected Forecasts*, by Gail Makinen,.

[2] National Bureau of Economic Research, Business Cycle Dating Committee, *The Business-Cycle Peak of March 2001* (Cambridge, MA, Nov. 26, 2001).

[3] See, for example, Brett Ferguson, "Need for Stimulus Package Put in Question As Signs of Recovery Grow, Economists Say," *Daily Report for Executives*, Bureau of National Affairs, Nov. 19, 2001, p. C-1.

[4] For more details on economic stimulus legislation in the 107th Congress, see CRS Issue Brief IB10068, *Major Tax Issues in the 107th Congress*, by David L. Brumbaugh.

[5] The projected revenue loss from a repeal shrinks between FY2002 and FY2011 because CAMT credits that would be claimed over that period under current law would be refunded in one lump sum in FY2002 under H.R. 3090 as passed by the House.

economy, the Senate Finance Committee approved along party lines an amended version of H.R. 3090 on November 8, 2001 that would result in a smaller reduction in federal tax collections over 10 years ($52.2 billion). Its smaller budgetary cost reflects the fact that it would provide fewer and smaller cuts in business taxes than the version passed by the House. The full Senate has yet to consider the measure, mainly because it has failed to attract the support of 60 senators, which is the minimum number of votes needed to pass legislation that would violate budget agreements.

The impasse over Senate action on H.R. 3090 has spawned other efforts to enact an economic stimulus package. Seeking a compromise that achieves his main priorities, President Bush proposed in mid-December 2001 an economic stimulus package that would be less costly than the House-passed version of H.R. 3090. The proposal included a combination of individual and business income tax cuts, but it would not repeal the CAMT. Acting with dispatch, the House passed a bill incorporating many elements of the President's plan (H.R. 3529 – the Economic Security and Worker Assistance Act of 2001) on December 20, 2001. The measure would, among other things, substantially reduce the burden of the CAMT by eliminating the adjustment for depreciation allowances and the 90% limitations on the use of net operating loss deductions and foreign tax credits under the CAMT. Once again, though, the Senate has yet to consider the measure, largely because of partisan disagreements over how best to revive the economy. These disagreements have resurfaced in the second session of the 107th Congress. On February 6, 2002, the Senate passed by unanimous consent an amended version of H.R. 622 that would extend unemployment benefits by 13 weeks, after failing to agree on a variety of individual and business tax cuts. Eight days later, the House passed a modified version of H.R. 622 that included many of the tax cuts contained in H.R. 3529.

The attempt to eliminate the CAMT or sharply curtail its impact has rekindled a longstanding debate over the economic effects of the tax. On the one hand, those in favor of repealing the CAMT argue that doing so would spur economic growth by enabling corporations to hire more workers and invest more in plant and equipment – particularly during periods of weak or declining sales. On the other hand, opponents of repeal maintain that getting rid of the tax would do little to boost business investment but would enable numerous large profitable corporations to avoid paying federal income tax, undermining the progressivity of the federal income tax, and harm the long-term outlook for the federal budget.

Without addressing the question of whether additional fiscal stimulus is needed to pull the U.S. economy out of recession in 2002, this report assesses the potential stimulative effect of a repeal of the CAMT. It begins with a description of the structure of the tax and moves on to discuss its importance as a source of federal revenue and which firms pay it. The report then examines what is known about the effect of the CAMT on business investment incentives and concludes with an evaluation of its potential effectiveness as an economic stimulus tool.

Structure of the Corporate Alternative Minimum Tax

The CAMT originated with the Tax Reform Act of 1986, which eliminated an "add-on" minimum tax imposed on corporations under the Tax Reform Act of 1969 and replaced it with a minimum tax that has evolved into the current CAMT.[6] In general, minimum taxes are intended to raise income tax payments from taxpayers who are thought to pay too little tax relative to their incomes

[6] The "add-on" tax was equal to 15% of the excess of certain corporate tax preferences over the greater of a firm's regular income tax liability or $10,000. It functioned like an excise tax on a set of tax preferences above a certain amount.

because of preferences in the regular income tax code. A central aim of the CAMT since its inception has been to prevent corporations that report substantial profits under generally accepted principles of financial accounting from paying little or no federal corporate income tax.

Under current federal tax law, all corporations – except those that are relatively small in revenue size – are required to compute their regular income tax and CAMT liabilities and pay whichever is larger.[7] In essence, the CAMT constitutes a separate and distinct tax system in that it has its own rules for the measurement of income, the determination of deductions, and the treatment of such key corporate tax attributes as the basis of depreciable assets, value of inventory, net operating losses (NOLs), and foreign tax credits. Though it follows many of the rules of the regular tax, the AMT applies a relatively low but fixed statutory rate to a broader definition of taxable income and a less generous set of deductions.[8] Many business tax credits available under the regular tax (e.g., the research and experimentation tax credit, the investment credit, and the orphan drug credit) cannot be used to reduce AMT tax liability; nor can these credits be used to reduce regular tax liability below minimum tax liability before allowable credits.

Calculating the AMT involves some complicated steps. The starting point is a corporation's taxable income before NOL under the regular tax. This amount is then modified by a series of calculations known as adjustments and preferences. Generally, these calculations entail the use of less generous methods of determining certain deductions and the disallowance of certain tax preferences. Their combined effect is to increase a firm's regular taxable income. Adjustments can either raise or lower corporate minimum taxable income, whereas removing preferences enters the equation only to the extent that such a correction increases this taxable income. Adjustments include a portion of accelerated depreciation on buildings and equipment, amortization of pollution control facilities, 75% of the difference between adjusted current earnings (ACE) and alternative minimum taxable income (AMTI), mining exploration and development expenditures, income reported under the contract method of accounting, and installment sales income. Preferences include percentage-depletion allowances, intangible drilling costs, deductions for bad debt held by financial institutions, and tax-exempt interest on certain bonds.

After adding the sum of adjustments and preferences to its regular taxable income, a corporation is allowed to reduce that amount by up to 90% by subtracting NOLs carried back or forward from other years.[9] This step results in the corporation's AMTI. A firm is then allowed a maximum exemption from AMTI of $40,000.[10] Whatever amount remains after the exemption is multiplied by 20% to yield a corporation's tentative minimum tax before credits. Foreign tax credits, calculated according to AMT principles and using the AMT tax rate, may be taken against this tentative minimum tax, but the combination of foreign tax credits and NOLs may offset no more than 90% of the tax otherwise owed. The result is the tentative alternative minimum tax (TAMT),

[7] The Taxpayer Relief Act of 1997 exempted small corporations from the AMT beginning in 1998. Small corporations are defined as corporations whose average annual gross receipts do not exceed $5 million in the three tax years before the exemption is first claimed. They remain exempt as long as their average annual gross receipts do not exceed $7.5 million in each succeeding three-year period.

[8] The rate for the AMT is 20%. By contrast, the regular corporate income tax has a graduated rate structure that ranges from 15% on taxable income up to $50,000 to 35% on taxable income over $18.3 million. Many large corporations subject to the regular tax pay the maximum rate of 35%.

[9] For the purpose of the AMT, a corporation is required to compute its NOLs on the basis of its AMT taxable income in past years, rather than its regular taxable income.

[10] The exemption phases out for corporations with alternative minimum taxable incomes between $150,000 and $310,000.

which is compared to the corporation's regular tax liability before all business credits except the foreign tax credit. If the TAMT is larger, then the firm pays the excess as its AMT and the remainder as its regular tax. But if its regular tax liability exceeds its TAMT, the firm may further lower its regular tax to equal its TAMT by claiming allowable business credits. This rule is noteworthy because it means that the CAMT can increase the tax liability of corporations that have large amounts of business credits but pay no CAMT by delaying the use of these credits.[11]

Differences in the timing of certain deductions account for much of the increase in a firm's tax liability under the CAMT. In general, these deductions are taken sooner under the regular tax. However, in the absence of a system of credits or adjustments to the basis of depreciable assets, the CAMT could end up collecting taxes worth more than the value of the timing advantages provided by the regular tax.[12] To prevent such an overpayment, current tax law grants firms paying the CAMT a tax credit for their CAMT payments and provides a separate measure of the basis of depreciable assets under the CAMT. The CAMT tax credit may be used only to offset future regular tax liability and can be carried forward indefinitely. Moreover, the credit may not be used to reduce a firm's regular tax liability below its TAMT – which is the same floor limiting the use of most business credits under the regular tax. If a firm were to respond similarly over time to the CAMT and to the regular tax, and if it were to pay the CAMT over five tax years and then claim all its CAMT credits in the next five tax years, its total tax liability over the 10 years would be the same as it would be if the firm were to pay the regular tax only in that period. This equivalence indicates that the CAMT results in an acceleration of income tax payments. It also implies that the credit is intended to keep firms moving in and out of CAMT status from paying a double tax on income that is deferred under the regular tax but recognized earlier under the CAMT because of the adjustments and preferences. In effect, the net cost of the CAMT to a firm is the cost of financing this prepayment of tax liability.

Owing to the design of the CAMT, firms with large amounts of adjustments or preferences or large amounts of NOLs or foreign tax credits relative to their current income are likely to be subject to the CAMT in a given tax year. Most firms that pay the tax do so because of the CAMT depreciation adjustment and the ACE adjustment: in 1998, the former accounted for 80% of the combined value of adjustments and preferences, and the latter for 30%.[13] While cost recovery periods for depreciable assets under the regular tax and the CAMT have been identical since January 1, 1999, depreciation methods for many types of equipment are more accelerated under the regular tax than the CAMT.[14] Specifically, property eligible for the 200% declining balance method under the regular tax must be depreciated using the slower 150% declining balance method under the CAMT. As a result, the firms most likely to pay the CAMT in a given tax year are those that invest heavily in plant and equipment relative to earnings during periods of slow or negative growth in revenues.

[11] Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington: Brookings Institution, 1997), p. 25.

[12] Ibid., p. 25.

[13] The sum of these two adjustments exceeds 100% because other adjustments, notably the basis adjustment, may be negative. See Curtis P. Carlson, *Who Pays the Corporate Alternative Minimum Tax? Results from Corporate Panel Data for 1987-1998* (Washington: Department of the Treasury, Nov. 10, 2001), Table 12, p. 18.

[14] This equivalence is the result of the Taxpayer Relief Act of 1997. For property placed in service after 1986 and before 1999, recovery periods under the AMT ranged from the same as under the regular tax to over twice as long.

Importance and Incidence of the Corporate Alternative Minimum Tax

It appears that the absolute and relative importance of the CAMT as a source of federal revenue shrank considerably in the 1990s.[15] In 1998, the most recent year for which detailed published data are available, CAMT payments totaled $3.3 billion, their smallest amount since 1987, the first year of the tax.[16] CAMT payments peaked at $8.1 billion in 1990, when the U.S. economy was last in a recession, and decreased gradually through 1998. The CAMT's share of total corporate income tax revenue has also been falling: in 1998, it accounted for 1.8% of total federal income taxes paid by corporations, its lowest share ever and down from a peak of 8.4% in 1990. In addition, 1998 marked the fourth consecutive year in which redemptions of CAMT credits by corporations exceeded CAMT payments. The value of accumulated CAMT credits stood at $22.9 billion, the lowest level since 1992.

This decline in the importance of the CAMT as a source of revenue appears to stem from several significant changes to the tax enacted in the 1990s and the pro-cyclical nature of the tax. The Omnibus Budget Reconciliation Act of 1993 (OBRA93) repealed the depreciation component of the ACE adjustment for assets placed in service after 1993. And, as previously noted, the Taxpayer Relief Act of 1997 removed differences in the cost recovery periods for depreciable assets under the CAMT and the regular tax and repealed the CAMT for small corporations. The design of the CAMT makes the tax pro-cyclical in that CAMT payments tend to decrease during periods of sustained economic expansion – such as most of the 1990s – when regular corporate tax liabilities rise relative to CAMT liabilities, and to increase during periods of economic contraction.

Firms are affected by the CAMT either by having to pay it or having their use of tax credits limited by the tentative minimum tax. The number of corporations affected by the CAMT reached a low of 30,226 in 1998, or 33% fewer than the number affected in 1990. Of the corporations affected in 1998, 61% (or 18,352) made CAMT payments, while the remaining 39% (or 11,847) were constrained in their use of business tax credits. At any rate, very few corporations are affected by the CAMT in a given tax year: in 1998, for example, they accounted for 2% of all corporations filing federal income tax returns. A large proportion of firms paying the CAMT typically are in a loss status for the regular corporate income tax: in 1998, for example, about 62% of firms paying the CAMT were in such a status.[17] Nevertheless, the duration of CAMT exposure appears to be brief. Carlson found that about half of a sample of 9,012 firms with assets greater than $50 million and for which continuous tax return data are available were unaffected by CAMT in the six years from 1993 to 1998, whereas less than 9% of the firms were affected by the CAMT in five or six of the years in that period.[18]

One useful measure of the burden of a business tax is the percentage of a firm's or industry's assets subject to it. By this measure, it appears that the CAMT imposes a significant burden on the corporate sector. In 1998, firms affected by the CAMT accounted for 27% of corporate assets but represented only 2% of the number of corporations filing federal tax returns. This disparity

[15] The primary source for the data discussed in this section is a recent report by Curtis Carlson of the Office of Tax Analysis at the Treasury Department. See Carlson, *Who Pays the Corporate Alternative Minimum Tax?*

[16] Carlson, *Who Pays the Corporate Alternative Minimum Tax?*, Table 3, p. 11.

[17] Ibid., p. 5.

[18] Ibid., Table 14, p. 19.

implies that large firms pay most of the CAMT. In fact, between 1987 and 1998, firms with assets over $1 billion accounted for between 64% and 78% of CAMT payments.[19] And in 1998, only 0.5% of firms with assets of less than $1 million were affected by the CAMT, whereas 26% of firms with assets over $1 billion were affected.

Not only does the incidence of the CAMT vary by firm size, but it also differs by industry. Generally, differences among industries in who pays the tax are due to variations among industries over time in profits, concentration of firm sizes, and investment in equipment. In 1998, the proportion of firms in major industries affected by the CAMT ranged from 0.7% in services to nearly 7% in utilities.[20] The tax seems to impose the biggest burden on firms in four industries: manufacturing, mining, transportation and warehousing, and utilities. In 1998, 51% of assets in manufacturing were held by firms affected by the CAMT; in mining, the share was 47%; in transportation and warehousing, 37%; and in utilities 32%.

Impact of the Corporate Alternative Minimum Tax on Business Investment Incentives

Business executives weigh numerous factors in making investment decisions. Among the important ones are the cost of capital; expected returns on alternative investment projects; current and expected future operating profits; future demand for their firms' output; the location of investment; the best production technology to employ; likely actions of competitors; local, state, and federal government regulations and future changes in them; and taxes. In such a complex environment, executives assess these factors and then decide whether the expected after-tax return on a proposed investment project justifies its risk and cost.

In theory, income taxes affect business investment mainly through their impact on the cost of capital. This cost, which includes the opportunity cost of funds, can be thought of as the return an investment project must earn in order to break even. Rational investors would want to undertake projects whose expected rates of return exceed the cost of capital, and to abandon projects whose expected rates of return fall below this cost. All other things being equal, taxation of the returns to new investments raises the cost of capital, and as this cost rises, fewer investment projects are undertaken. Of course taxation of the income generated by new investments can be made more or less favorable to the owners of a firm by altering the rules governing this taxation. The more favorable the tax treatment, the lower the cost of capital for new investment. In addition, income taxes can influence business investment by increasing or decreasing the cash flow of firms that rely heavily on internal funds to finance investments. For such firms, access to debt or equity markets is extremely limited or non-existent.

How does the CAMT affect a firm's incentive to invest? Because the CAMT constitutes a parallel income tax system, the question should be answered in the context of the investment incentives of firms under the regular tax. At first glance, it appears that the net effect of the CAMT is inescapably ambiguous. On the one hand, the cost of an investment is recovered slower under the CAMT than under the regular tax, which implies that a firm paying the CAMT has a higher cost of capital than it would if it were to pay the regular tax. On the other hand, income from a new investment is taxed at a flat 20% rate under the CAMT, as opposed to a top marginal rate of 35% under the regular tax. This difference implies that the cost of capital for a firm paying the CAMT typically is lower than that of a firm subject to the regular tax. It may seem paradoxical that the

[19] Ibid., p. 5.

[20] Ibid., Table 8, p. 15.

CAMT has the potential to lower a firm's cost of capital for new investment when firms subject to the CAMT, by definition, have higher tax liabilities than firms subject to the regular tax in a particular tax year. But just because the CAMT increases a firm's average tax rate – which, of course, is the rate that applies to the returns on past investments – does not mean that, in theory, the tax cannot also give a firm subject to it a lower cost of capital for new investment projects than a firm subject to the regular tax. The incentive to pursue new investment projects is significantly affected by the tax treatment of their expected returns.

Further analysis appears to confirm that the CAMT ultimately has an indeterminate effect on the corporate investment incentives, relative to the regular tax. This uncertainty arises mainly from the mix of factors that determines how the tax affects the cost of capital for new investment, their multitude of possible combinations, and the great difficulty firms face in accurately predicting shifts from CAMT status to regular tax status and vice versa and the duration of exposure to each tax. The primary factors are a firm's initial tax status, the method of financing, the type of asset purchased, and the duration and timing of CAMT exposure.

A few examples can illustrate the ambiguous impact of the CAMT on business investment. In analyzing the relative effects of the CAMT and regular tax on the cost of capital for new investment, three scenarios are relevant: (1) a firm that is permanently subject to the CAMT; (2) a firm that undertakes an investment project when it is subject to the CAMT and switches to the regular tax while the project continues to generate earnings; and (3) a firm that undertakes an investment project when it is subject to the regular tax and switches to the CAMT while the project continues to generate earnings. A large firm permanently subject to the CAMT has a lower cost of capital for new investments than a large firm that permanently pays the regular tax, because the rate of the CAMT is 43% lower than the maximum rate of the regular tax: 20% versus 35%. But if the same firm were to purchase new equipment with a relatively short useful life for tax purposes when it was subject to the CAMT and then switch to the regular tax three years later and remain on it indefinitely, its cost of capital would rise (relative to the CAMT firm in the first scenario) because the initial depreciation deductions would be taken at a lower rate (as a result of temporary exposure to the CAMT), but a significant share of the returns on the investment probably would be taxed at a higher rate (as a result of the switch to the regular tax). Finally, if the firm were to purchase the same equipment while subject to the regular tax and then switch to the CAMT three years later and remain on it indefinitely, its cost of capital would fall (relative to the CAMT firm in the first scenario) because the opposite effects would prevail: initial depreciation deductions would be taken at a higher rate (because of the regular tax), but much of the income from the investment would be taxed at the lower rate of the CAMT.

A 1997 study by economist Andrew B. Lyon, the present Deputy Assistant Secretary of the Treasury for Tax Analysis, shed further light on the uncertain effects of the CAMT on business investment incentives. Among other things, he estimated and compared the cost of capital (net of depreciation) for investment under different financing methods in major categories of assets by a firm subject to the CAMT over varying periods and by a firm permanently facing the regular tax.[21] He found that under pre-OBRA93 tax law, the cost of capital was significantly higher for a firm paying the CAMT over five consecutive years, investing in equipment and intangible capital such as R&D, and financing one-third of the investment with debt; but the cost of capital was the same or slightly lower for a CAMT firm investing in structures, inventory, and land and financing one-third of the investment with debt.[22]

[21] Lyons, *Cracking the Code*, pp. 81-93.

[22] Ibid., p. 86.

Lyon also estimated the cost of capital for investment in equipment financed solely with equity for a firm paying the CAMT over five years and a firm permanently paying the regular tax under two other scenarios: (1) the changes in the CAMT introduced by OBRA93, and (2) an approximation of the changes in CAMT introduced by the Taxpayer Relief Act of 1997. Despite these changes in tax law – which reduced the burden of the CAMT on corporate income – the cost of capital for the CAMT firm was still larger, but the gap was two-thirds what it was under pre-OBRA93 tax law.[23] In addition, Lyon found that durations of CAMT liability from five to 10 years raised the cost of capital for a CAMT firm more than shorter durations did, and that the cost of capital for debt-financed investment was increased more by the CAMT than the cost of capital for equity-financed investment.

How might firms respond to the reduced investment incentives associated with CAMT exposure? At least three possibilities are likely. First, firms could curtail investment in equipment and intangible capital during periods of CAMT liability. There is some evidence that such a response occurs. Lyon estimated that from 1988 to 1992, firms that paid the AMT in one year invested 5% less in the following year than they would have if they had paid the regular tax in both years.[24] Second, firms anticipating a switch from regular tax status to CAMT status (and vice versa) may alter the timing of their investments in equipment and intangible assets so that the investments take place when they pay the regular tax. Such a response could involve either a postponement of investment by a firm currently paying the CAMT or an acceleration of investment by a firm currently paying the regular tax. Third, firms subject to the CAMT for an extended period may find it more advantageous to lease assets than to purchase them. Through leasing, a firm with CAMT status can, in theory, obtain capital at a cost similar to that of firms subject to the regular tax. If the lessor pays the regular tax, the lessee should be able to lease an asset at a price that reflects the investment incentives of the regular tax, assuming that the rental market for the asset is perfectly competitive.[25]

It is unclear which response, if any, prevails. What seems clear, however, is that regardless of the extent to which the CAMT reduces a firm's incentive to invest, there is no reason to believe that the tax causes a permanent decline in the economy's capital stock. Firms facing CAMT status may alter the timing of their investments so that they are made during periods when they pay the regular tax, or they may expand their reliance on leasing to acquire new plant and equipment. In addition, as Lyon has noted, reductions in investment by firms paying the CAMT could be offset by increased investment by firms in the same or other industries that are subject to the regular income tax.[26] Such an outcome is possible in part because for some investments the cost of capital is lower for firms facing the regular tax and firms subject to the CAMT are more likely to have difficulties financing new investments out of retained earnings.

Likely Stimulative Effect of a Repeal of the Corporate Alternative Minimum Tax

In view of the consensus among economists that the U.S. economy is either still in a recession or entering a period of weak recovery, and given that a key factor behind the recent downturn has

[23] Ibid., pp. 91-92.

[24] Ibid., p. 123.

[25] Ibid., p. 124.

[26] Ibid., p. 126.

been a sharp drop in business investment spending since mid-2000, how much economic activity is likely to be stimulated by a repeal of the CAMT in the short run?

Most economists agree that an effective stimulus package would consider the current state of the economy as well as the outlook for the federal budget. Ideally, in their view, it would spur substantial new economic activity in the short run without indirectly restraining this activity by driving up long-term interest rates. Moreover, such a package would expand automatically if a downturn turns out to last longer and be more severe than expected but phase out automatically when the economy begins to grow again. These principles imply that if a stimulus package is to be built around tax incentives for business investment, the incentives should be targeted at new investment projects rather than both old and new projects. They also imply that the tax incentives should be in place long enough to stimulate an upturn in business investment but not so long that they put upward pressure on long-term interest rates through their effect on federal revenues. In the context of the current outlook for the federal budget in the next 10 years, a permanent tax cut is more likely to put upward pressure on long-term interest rates than a temporary tax cut tied to the level of overall economic activity.[27] A rise in these rates in response to an economic stimulus plan would dampen its effect on total output and employment by curtailing spending that is sensitive to changes in long-term interest rates, such as residential and nonresidential investment and consumer purchases of new motor vehicles.

How does a repeal of the CAMT – as proposed in H.R. 3090 – measure up to these principles? In a word, poorly. There are two reasons for such a poor fit. First, a repeal of the CAMT would be a permanent business tax reduction, not a temporary one. As a result, it would exact a higher budgetary cost than a temporary tax cut aimed at stimulating business investment. Second, an elimination of the CAMT accompanied by an immediate rebate of accumulated CAMT credits would affect the returns on both old and new investments. In fact, it would benefit certain corporations regardless of whether they increase investment in the short run. As such it would be less effective in spurring new economic activity in the short run than a tax cut targeted at new investments only.

These considerations suggest that a repeal of the CAMT would be likely to stimulate a relatively small increase in business investment in the short run. Other considerations seem to reinforce this conclusion. As discussed in the previous section, the CAMT's overall effect on the user cost of capital is ambiguous. Thus, its repeal would be likely to stimulate business investment mainly through the mechanism of increasing the cash flow of firms that are affected by it. In the short run, getting rid of the tax and refunding unused CAMT credits would decrease the average tax rate for corporate income as a whole, putting more funds in the hands of corporate executives to use as they see fit. But under current economic conditions, it is unlikely that all or most of whatever infusion of cash would result from a repeal of the CAMT would be spent on new investment. A primary problem facing many firms selling in the U.S. market today is that their customers are reducing or not increasing their purchases. For the average U.S. nonfinancial corporation, a pressing concern nowadays appears to be not a shortage of cash and other liquid financial assets but a shortage of demand for its goods and services.[28]

[27] In its latest assessment of the outlook for the federal budget, the Congressional Budget Office projects that the budget will run small deficits in FY2002 and FY2003, and that the cumulative surplus in fiscal years 2002 through 2011 will total $1.6 trillion, or $4 trillion less than the surplus projected in January 2001.

[28] According to data reported recently by the Board of Governors of the Federal Reserve System, U.S. industrial production fell by 5% between the first quarter of 2000 and the fourth quarter of 2001, the U.S. industrial capacity utilization rate was 9% lower in the fourth quarter of 2001 than in the first quarter of 2002, and total financial assets held by U.S. nonfinancial corporations were $317 billion greater at the end of the third quarter of 2001 than at the end of the first quarter of 2000.

In the face of such a problem, a significant boost in the cash flow of the corporate sector is more likely to be used to for purposes other than the purchase of new plant or equipment. Possible alternative uses include a reduction in debt, increased dividend payments, acquisitions of assets held by other firms, and repurchases of stock to boost its price. Furthermore, while an increase in cash flow may boost investment by firms that are cash-constrained, there is reason to question that many of the corporations that would benefit from a repeal of the CAMT are in such a position. Especially in current economic conditions, small, fledgling firms are more likely to have difficulty raising capital for new investment in debt or equity markets than large, established firms. For the latter group of firms, the cost of external funds is significantly greater than the cost of internal funds. Yet large firms are much more likely to be affected by the CAMT than small firms. In 1998, for example, firms with assets valued at $500 million or more accounted for 73% of CAMT payments.

Conventional economic analysis indicates that a repeal of the CAMT would be likely to stimulate less investment in the short run than temporary tax cuts targeted at new investment. Such measures include a temporary investment tax credit or temporary accelerated depreciation for the cost of new plant and equipment (e.g., partial expensing of this cost as proposed in H.R. 3090 as passed by the House and the Senate Finance Committee). They are likely to be more effective in spurring economic growth in the short run by inducing firms to accelerate planned investment projects to take advantage of the temporary tax breaks. Firms that elect to build new plants or purchase new equipment now rather than in the distant future expand national output and employment by purchasing materials, equipment, and services from other firms.

In addition, recent reports by the Congressional Budget Office and CRS conclude that temporary investment tax incentives are also likely to have a greater bang for the buck than a repeal of the CAMT.[29] According to revenue estimates prepared by the congressional Joint Committee on Taxation, a repeal of the CAMT accompanied by an immediate refund of unused CAMT credits would reduce federal revenues by $24.1 billion from FY2002 to FY2011, whereas a one-year, 10% expensing allowance for the purchase of short-lived capital assets would have a revenue cost of only $2.2 billion in the same period.[30] Of course, there is no certainty that such incentives will work as intended. Their impact on business investment could be limited at a time when many firms have significant holdings of liquid financial assets, there is excess capacity, aggregate demand is falling or stagnant, and many corporate managers are averse to doing anything that would make their firms' current profit statements look worse than they already are.

This is not to suggest that there would be no economic benefits from repealing the CAMT. By lowering the federal tax burden on corporate capital and lessening the uncertainty faced by firms that move on and off the tax, a repeal could lead to increased business investment and a more efficient use of resources in the long run. It would also significantly lower the cost and complexity of administering the federal tax code. But these potential gains are likely to emerge over the long run and would do little to raise economic growth in the short run.

[29] See Jane Gravelle, *Using Business Tax Cuts to Stimulate the Economy*, pp. 5-7; and U.S. Congress, Congressional Budget Office, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, p. 27.

[30] U.S. Congress, Joint Committee on Taxation, *Revenue Estimate Comparison of Economic Stimulus Bills As Passed by the House and Pending in the Senate (H.R. 3090)* (Washington: Dec. 5, 2001).

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